



The Covenant Loophole That Wasn't: SDNY Derides Windstream's Structuring Efforts as "Too Cute by Half"

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On February 15, 2019, following a full bench trial, the Honorable Jesse M. Furman (S.D.N.Y.) entered judgment in favor of Aurelius Capital Master, Ltd. ("Aurelius") and against Windstream Services, LLC ("Windstream") in the amount of \$310,459,959.10. Judge Furman further declared that Windstream had precipitated the acceleration of the amounts owing to Aurelius by violating the terms of the Indenture dated January 23, 2013 (the "Indenture") governing its 6.375% senior unsecured notes due 2023 (the "Notes"). In so ruling, Judge Furman rejected both Windstream's efforts to structure around the restrictions contained in the Indenture, as well as the company's after the fact efforts to rally other stakeholders to support a waiver of the resulting default. Ten days later, Windstream had filed for Chapter 11 relief in the United States Bankruptcy Court for the Southern District of New York.

Judge Furman's ruling offers an interesting point of contrast to the J. Crew/Eaton Vance dispute, wherein a borrower successfully utilized the terms of its credit agreement to transfer substantial asset value away from the borrower and to its unrestricted subsidiaries. Here, Judge Furman firmly rejected a hyper technical reading of the Indenture, and found the issuer to have triggered a default by engaging in a prohibited sale leaseback transaction that substantially increased the company's Consolidated Leverage Ratio, even where the issuer had arguably structured around that prohibition. Judge Furman noted that Windstream's "financial maneuvers – and many of its arguments here – are too cute by half". In doing so, the court looked past the form of the transaction in question and instead focused on its substance. If the J. Crew dispute demonstrated that an issuer would not hesitate to unlock liquidity through the most aggressive reading of the "permitted investments" section of its credit agreement, the Windstream decision reminds us that judges still retain the power to police the borders of such agreement – particularly where the issuer's financial statements, operations and regulatory filings are inconsistent with the issuer's position.

The Transactions at Issue

In August 2013, the Windstream board of directors approved the formation of a new parent holding company, Windstream Holdings, Inc. ("Holdings").

In 2015, Windstream and Holdings engaged in a series of transactions as follows (the "2015 Transactions"):

- In March 2015, certain restricted subsidiaries of Windstream (the "Transferor Subsidiaries") transferred material assets (the "Transferred Assets") to Windstream, which in turn transferred those assets to a newly-formed wholly-owned REIT subsidiary, Uniti Group, Inc. (at such time known as Communications Sales & Leasing, Inc.) ("Uniti") and certain of Uniti's subsidiaries. In exchange for the transfer of the Transferred Assets, Windstream received, among other things, all of the common stock of Uniti.
- In March 2015, following the transfer of the Transferred Assets, Windstream transferred the majority of the Uniti common stock to Holdings and Holdings transferred all such Uniti common stock to its shareholders, at which point the Uniti common stock became publicly traded.
- In April 2015, Holdings entered into a master lease agreement with Uniti (the "Master Lease") pursuant to which Holdings was granted the exclusive right to use the Transferred Assets.



The Ruling

If the Master Lease had been entered into by the Transferor Subsidiaries (instead of Holdings), the transactions described above would have violated the prohibition against Sale and Leaseback Transactions set forth in the Indenture. Windstream took care to keep the Transferor Subsidiaries off the Master Lease, so as to avoid this prohibition. Judge Furman was wholly unpersuaded by these structuring efforts, pointing instead to the economic reality of the 2015 Transactions, and Windstream's conduct following the consummation thereof, noting that "the Transferor Subsidiaries have entered into more than 120 agreements subleasing or otherwise granting rights in the Transferred Assets to third parties" and "in any number of these agreements, the Transferor Subsidiaries have explicitly represented that they are lessees under the Master Lease." The court further noted that the Transferor Subsidiaries have paid every monthly rent payment (over \$50 million per month) owed to Uniti under the Master Lease, pointing out that "[t]he fact that they make those payments indirectly through Holdings is of no moment. Holdings is a holding company with no operations and, thus, incapable of making the payments on its own." In short, as Judge Furman concisely noted, "... the Transferor Subsidiaries' use and enjoyment of the Transferred Assets walks like a lease and talks like a lease. That's because it is a lease."

In addition to the economic reality of the transactions, the court also based its opinion on the concept of judicial estoppel, which provides that a party cannot take a position in a legal proceeding that is contrary to a position such party took in an earlier proceeding. Over the course of 2014, Windstream sought approval from various state regulators to consummate the 2015 Transactions. As noted in the opinion by Judge Furman, Windstream "made explicit representations to nine state regulatory bodies that the Transferor Subsidiaries would transfer ownership of the Transferred Assets and then 'lease them back on an exclusive, long-term basis.'" Accordingly, the court noted that Windstream is judicially estopped from representing to state regulators that the Transferor Subsidiaries will lease the Transferred Assets, on the one hand, and then taking the position in this litigation that the Transferor Subsidiaries do not in fact lease the Transferred Assets, on the other hand.

Given Judge Furman's emphasis upon the underlying economic reality of the 2015 Transactions (and the resulting increase in leverage), as well as his reliance upon the doctrine of judicial estoppel, it seems fair to infer that Windstream's position had some foundation in the plain language of the Indenture. That Windstream lost so completely at the trial court level – notwithstanding a plain language justification for its position – demonstrates that extrinsic evidence and the supporting factual record can be equally important to defending (or attacking) the position taken by an issuer. Windstream took the position that the Master Lease was entered into by Holdings and thus not prohibited by the Indenture – but then took actions inconsistent with this position, particularly in its regulatory filings, financial statements and its dealings with third parties. These inconsistencies doomed what could otherwise be a plausible reading of the Indenture.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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